2017 Session

Revenue and Budget Outlook

November 17, 2016

Outlook for the 2017 Session

- Virginia's economic growth rate is slowing.
  - FY 2016 actual revenues below forecast, with growth of only 1.7%.
    - Revenues through first quarter of FY 2017 exceed the forecast.
  - SFC staff projects growth rates of 2.9% for the current year and 2.4% for FY 2018 remain below long-term trend of 5.5%.
    - Bright spots - job growth, housing, corporate profits.
    - Sales tax is weak; sequestration remains an unknown.

- 2016 Session actions produced a structurally balanced budget – a good starting point for dealing with a remaining problem of about $800 million.
  - Governor's proposed actions address the $861 million shortfall in the current fiscal year. SFC staff forecast estimates some additional resources.
  - Budget pressures from Medicaid, CSA, Corrections' medical costs, and employee health insurance add to the challenge for FY 2018.
    - Interest in restoring salary actions deferred due to revenue shortfall, but will be a challenge due to cuts required to balance the budget.

Recap of 2016: How did we get here?

- ***December 2015:*** Governor McAuliffe's biennial budget, SB 30 as introduced, included $3.4 billion in additional resources above the base budget.
  - Resources sufficient to cover mandated, high-priority budget items.
  - Additional resources available to address employee compensation, and make new investments in public and higher education, research, and economic development.
- ***February 2016:*** First hint of trouble - downward adjustment to sales and corporate income tax, offset by positive adjustments to refunds, recordation and insurance for FY 2016, and for FY 2017 and FY 2018.
- ***May/June 2016:*** Based on revenues through April, agencies directed to slow spending. In June, Governor indicated intention to reforecast revenues based on May year-to-date collections.

Recap of 2016: How did we get here?

- ***July 2016:*** FY 2016 GF collections fell short by $279.3 million, officially triggering the revenue reforecasting process.
  - GF revenues fell short $268.9 million, driven mainly by withholding and sales tax; transfers off by $10.4 million.
  - GF revenues grew 1.7%, instead of the forecast rate of 3.2%.
  - Reflected that job growth is primarily in <u>lower paying</u> occupations.

- ***August 2016:*** Governor McAuliffe presented an interim revenue forecast to the Joint Money Committees, based on the recommendations of the JABE and GACRE forecasting groups.
  - Growth rate lowered from 3.2% to 1.7% in FY 2017; from 3.9% to 3.6% in FY 2018.
  - Biennial revenues lowered by $1.2 billion from the official forecast in the budget adopted in March.
  - State agencies directed to develop budget reduction strategies.

Calculating the Revenue Shortfall

($ in millions)	FY 2016 Ch. 732	FY 2017 Ch. 780	FY 2018 Ch. 780
Official Revenue Forecast	$18,309.0	$18,902.4	$19,633.1
Actual / Interim Forecast	18,040.1	18,338.0	19,000.4
Revenue Variance	($268.9)	($564.4)	($632.7)
Transfers	(10.4)	(17.7)	(21.6)
Subtotal	**($279.3)**	**($582.1)**	**($654.3)**
* FY 2016 Balance Forward		($279.3)	0.0
Total		**($861.4)**	**($654.3)**
Total Shortfall			**($1,515.7)**

FY 2017 budget assumed a balance forward from FY 2016 of* *$265.3 million****.*

2016 Session Key Actions
Budgeting in an era of uncertainty

- **Reinforced "structural balance" in the budget.**
  - Used a portion of revenue growth for one-time uses.
    - Funded $605.6 million for required FY 2017 deposit to the Rainy Day Fund.
    - $10 million in cash for capital outlay.
  - Continued to unwind actions used to address prior budget shortfall.
    - Increased threshhold for retailers who pay accelerated sales tax.
  - Left few second-year holes in the budget.

- **Pre-payment of scheduled VRS obligations.**
  - Increased the employer contribution rates for the retirement plans to 100 percent of the Board rates by FY 2018, ahead of the scheduled phase-in.
  - Provided $172.7 million GF FY 2016 for early payoff of 10-year repayment for state employee groups. Results in rate savings in FY 2017 and FY 2018.

- **Actions help maintain Virginia's "triple-triple A" bond ratings.**

Strategies to Close the Gap in FY 2017

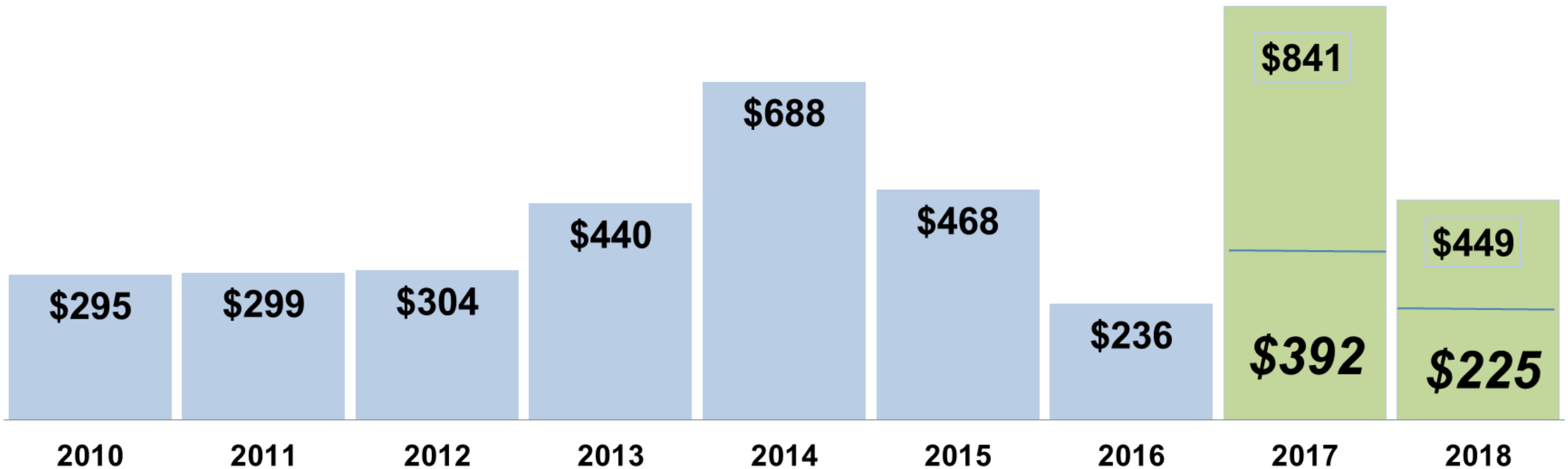
- Governor's proposed strategies include two triggered by the revenue shortfall – withdrawal from the Rainy Day Fund and elimination of salary actions.

Strategy	**FY 2017 GF, $ in millions**
Withdrawal from Revenue Stabilization Fund	$392.3
Remove Scheduled Pay Increase	125.1
Across-the-Board Agency Savings	73.0
Adjust Assumed FY 2017 Balance	70.0
Agency Balances	66.8
Lottery Balances, Forecast Adjustment	47.1
Adjust Accelerated Sales Tax (AST)	35.1
Literary Fund/GF Offset to Teacher Retirement	25.0
Recover HE NGF Share of VRS Savings	24.8
Other	15.9
TOTAL	**$875.1**

Rainy Day Fund can help cover over $600 million of two-year shortfall

Rainy Day Fund Balance
($ in millions)

- Deposit of $605.6 million required in FY 2017.
- Withdrawal of $392.3 million to help close FY 2017 gap, and $225.0 million in FY 2018.



FY 2016 Recap: GF Revenues Fell Short $268.9 Million

- GF revenues missed the forecast by 1.5 percent, driven by lower than expected payroll withholding and sales tax.
- Including transfers, the shortfall totaled $279.3 million.

Fiscal Year 2016 General Fund Revenues ($ in Millions)

Major Sources	Forecast	Actual	Variance	Change (%)	
				Forecast	Actual
Withholding	$11,501.6	$11,306.3	($195.3)	4.1	2.4
Nonwithholding	3,099.0	3,070.1	(28.9)	1.9	0.9
Refunds	(1,777.6)	(1,820.7)	(43.1)	1.2	3.6
Net Individual	$12,823.0	$12,555.6	($267.4)	4.0	1.8
Sales	$3,367.7	$3,295.9	($71.9)	4.1	1.9
Corporate	722.8	764.9	42.1	(13.1)	(8.0)
Recordation	383.0	369.1	(13.9)	10.6	6.6
Insurance	322.7	339.1	16.4	7.3	12.8
All Other	689.8	715.5	25.7	(0.4)	3.3
Total GF Revenue	**$18,309.0**	**$18,040.1**	**($268.9)**	**3.2**	**1.7**

First Quarter Results Above the Interim Forecast

- Individual and corporate income tax collections exceeded the revised interim forecast, but sales tax collections were essentially flat compared to last year.

First Quarter General Fund Revenues ($ in Millions)

Major Sources	FY 2016	FY 2017	Change (%)	
			Forecast	Actual
Withholding	$2,666.5	$2,777.0	3.0	4.1
Nonwithholding	472.0	470.8	(1.2)	(0.2)
Refunds	(122.9)	(114.9)	4.0	(6.5)
Net Individual	$3,015.6	$3,132.9	1.8	3.9
Sales	$648.9	$649.9	2.6	0.2
Corporate	188.0	197.5	(3.0)	5.1
Recordation	96.0	109.6	5.5	14.2
Insurance	-	-	1.3	-
All Other	117.9	121.8	(2.7)	3.3
Total GF Revenue	**$4,066.3**	**$4,211.3**	**1.7**	**3.6**
Sales w/out AST			3.7	0.2
Total w/out AST			**1.9**	**3.6**

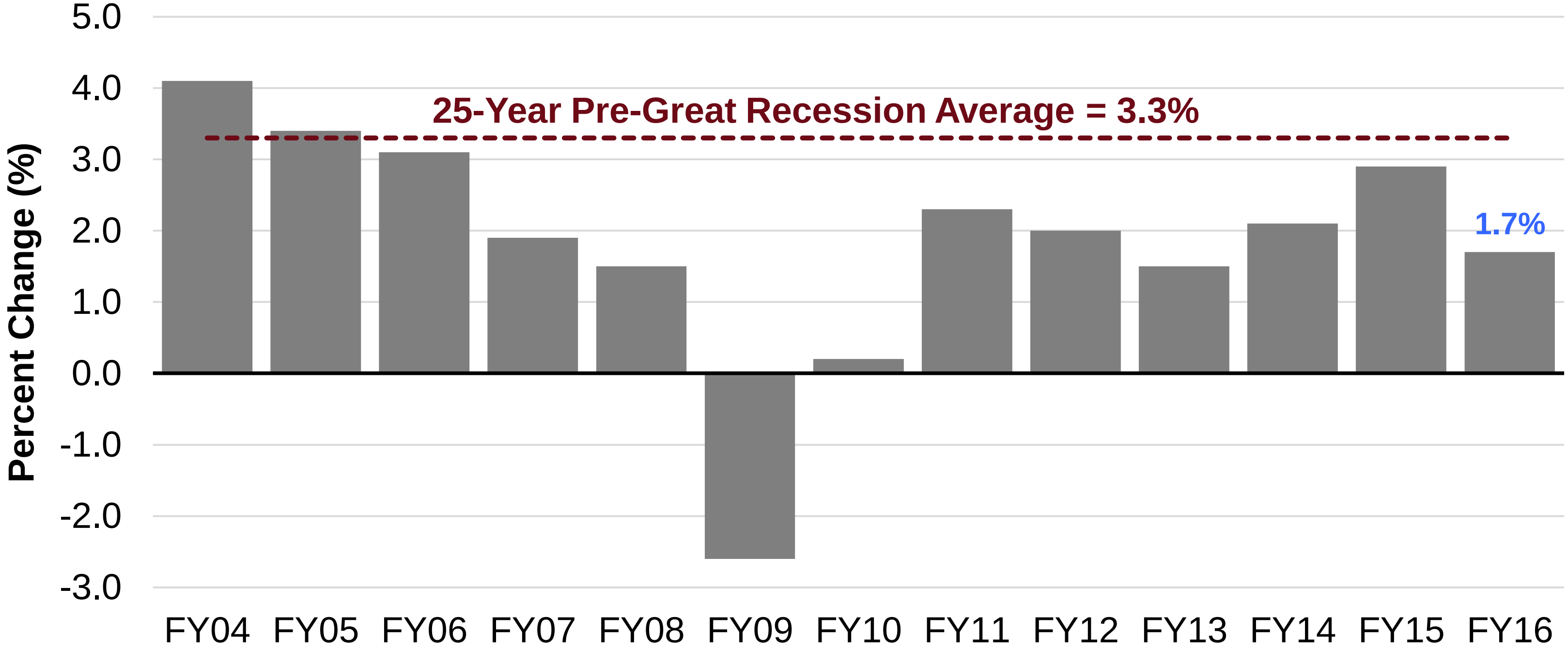
Slowly Growing Economy, Modest Revenue Growth

- On pace for growth of less than 2 percent in U.S. GDP for calendar year 2016, slower than the 2.4 percent growth in 2014 and 2015.
- Nationally, job growth has been good but slowing gradually. Gains are expected to slow further.
- Statewide employment growth slowed the last three quarters. Expected to slow to 1.5 percent and 1.0 percent in fiscal years 2017 and 2018.
- Despite the low unemployment rate, there is slack in the labor market which may dampen wage growth and hurt payroll withholding.
- Shifting patterns of consumer spending means continued weakness in sales tax growth.
- Housing market continues to rebound.
- Sequestration is still a concern. The Bipartisan Budget Act of 2015 increased caps by $50 billion in FY 2016 and $30 billion in 2017. Without federal action, caps will be lowered after September 2017.

U.S. Economic Growth Continues to Lag Long-Term Average

- U.S. GDP grew 1.7 percent in FY 2016. Similar growth is expected in FY 2017.

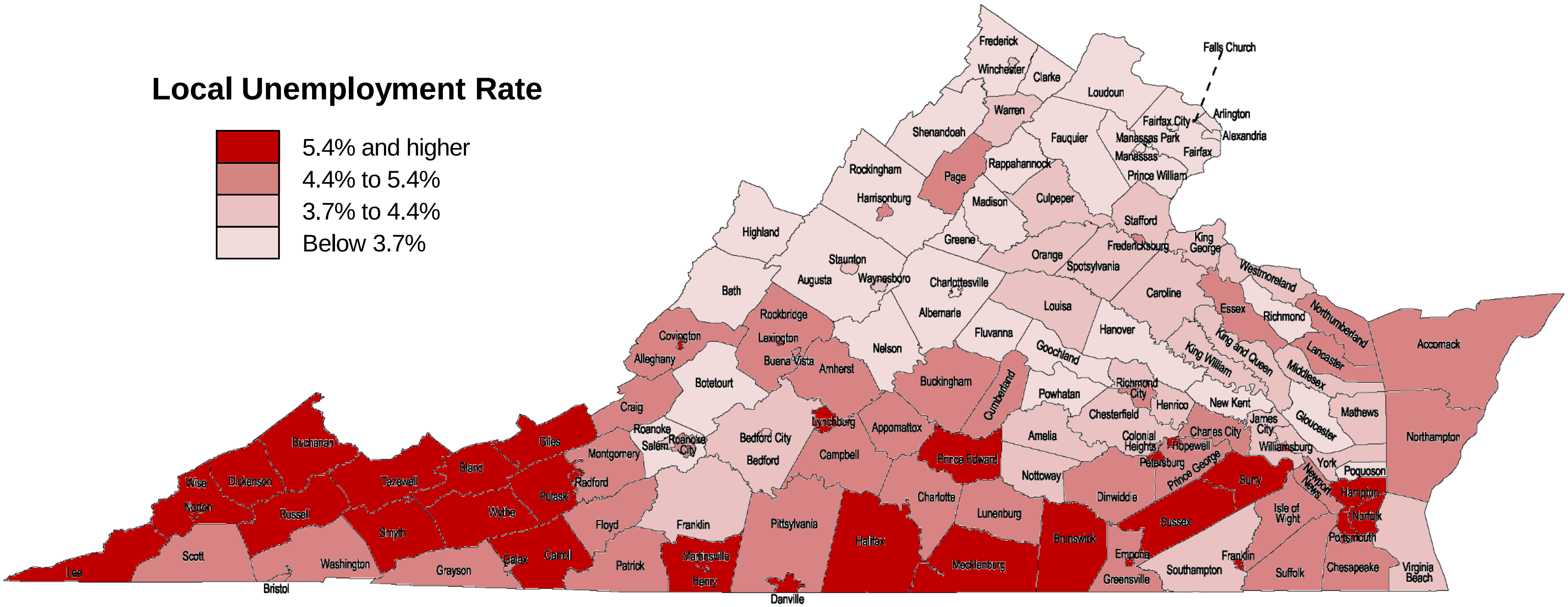
U.S. Real Gross Domestic Product, Percent Change from Preceding Period, Seasonally Adjusted Annual Rate



Source: *Virginia Department of Taxation, The Economic Outlook (appendix), November 9, 2016.*

Slow Recovery Has Been Uneven

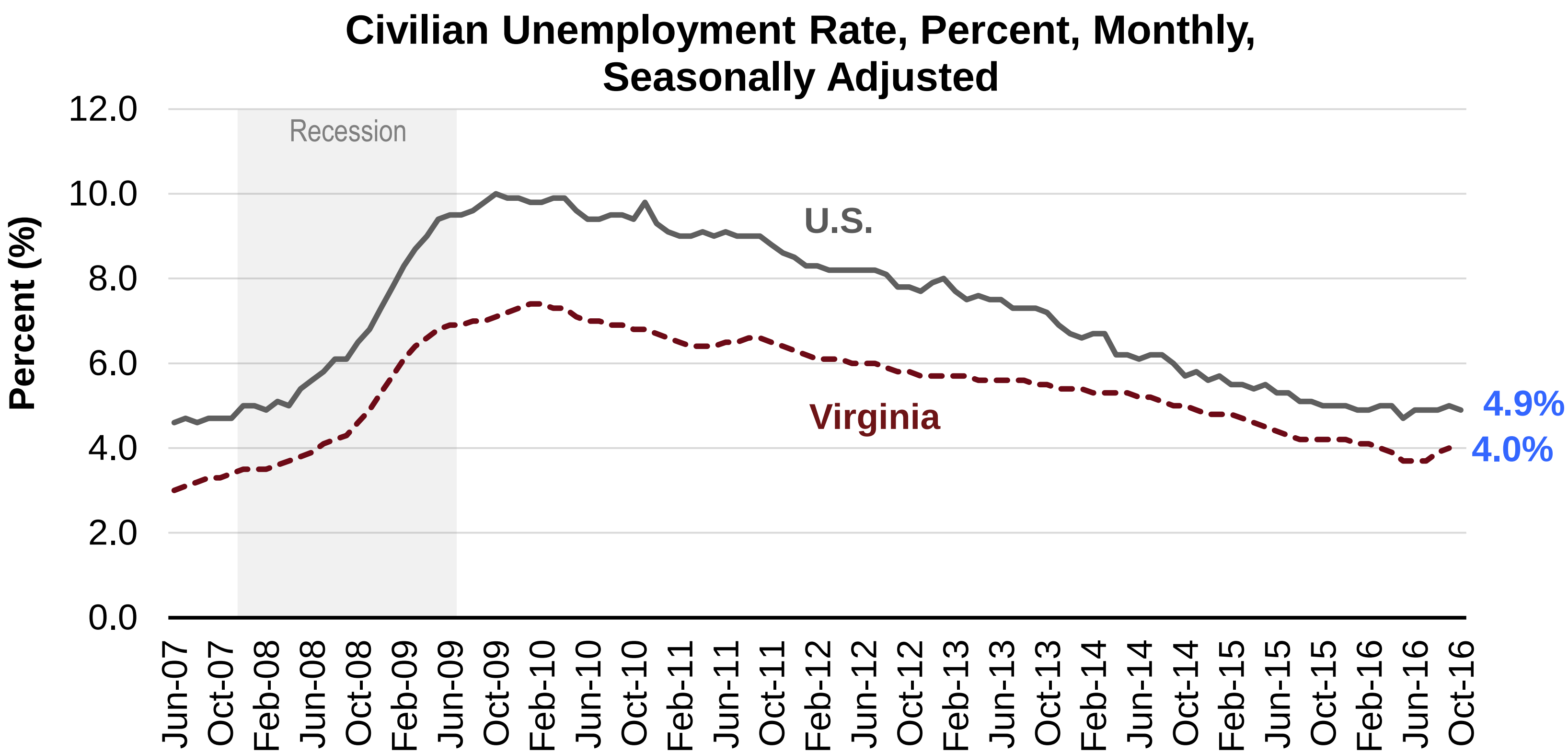
- Unemployment rates have improved significantly since the recession; however, the recovery has been uneven.
- Some areas of the Commonwealth still have unemployment rates as high as 9 to 10 percent.



Source: *Virginia Employment Commission (August 2016).*

Low Unemployment Beginning to Edge Higher

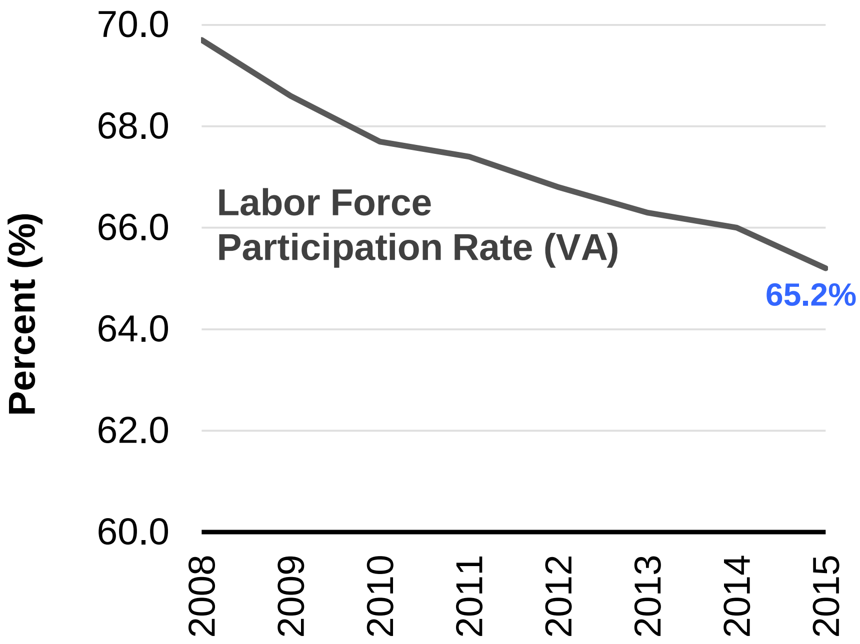
- Virginia's unemployment is well below post-recession highs, but ticked up in August and September as the number of job seekers increased.

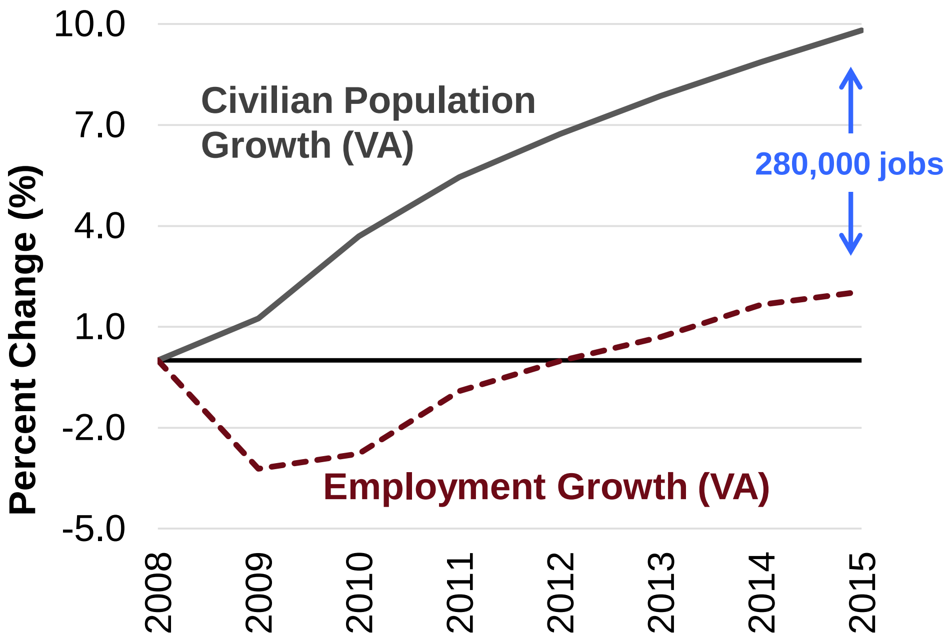


Source: *US. Bureau of Labor Statistics, Civilian Unemployment Rate [UNRATE], Unemployment Rate in Virginia [VAUR], retrieved from FRED, Federal Reserve Bank of St. Louis.*

Low Participation Rate Masks Weakness In Job Market

- Because of low participation, the unemployment rate is somewhat misleading.
- The labor market can absorb more (mostly less-skilled) job seekers without significant pressure on wages.

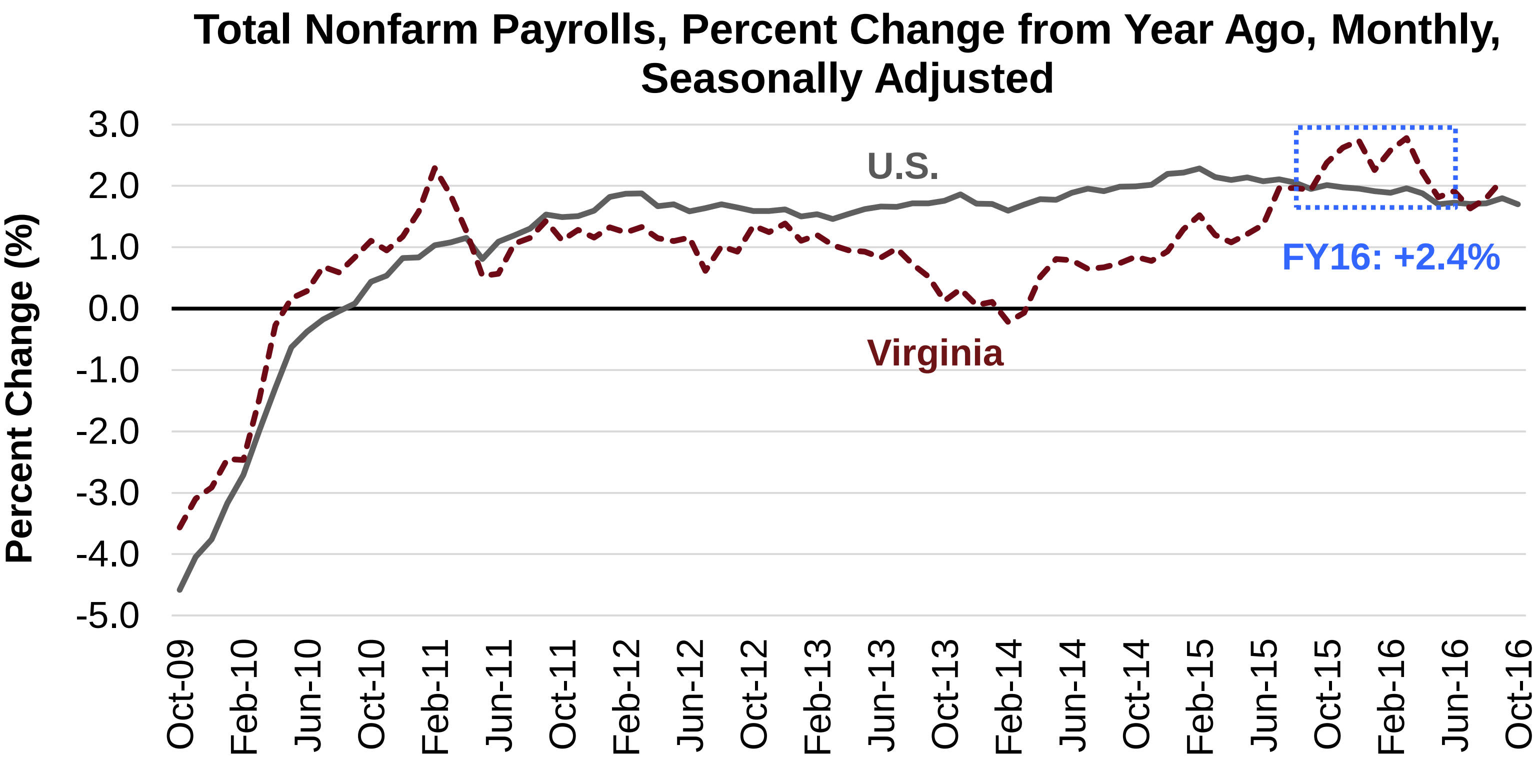




Source: *SFC staff analysis of data from US. Bureau of Labor Statistics, Local Area Unemployment Statistics, Employment status of the civilian noninstitutional population, 2008 to 2015 annual averages.*

Modest Growth in Virginia Payrolls

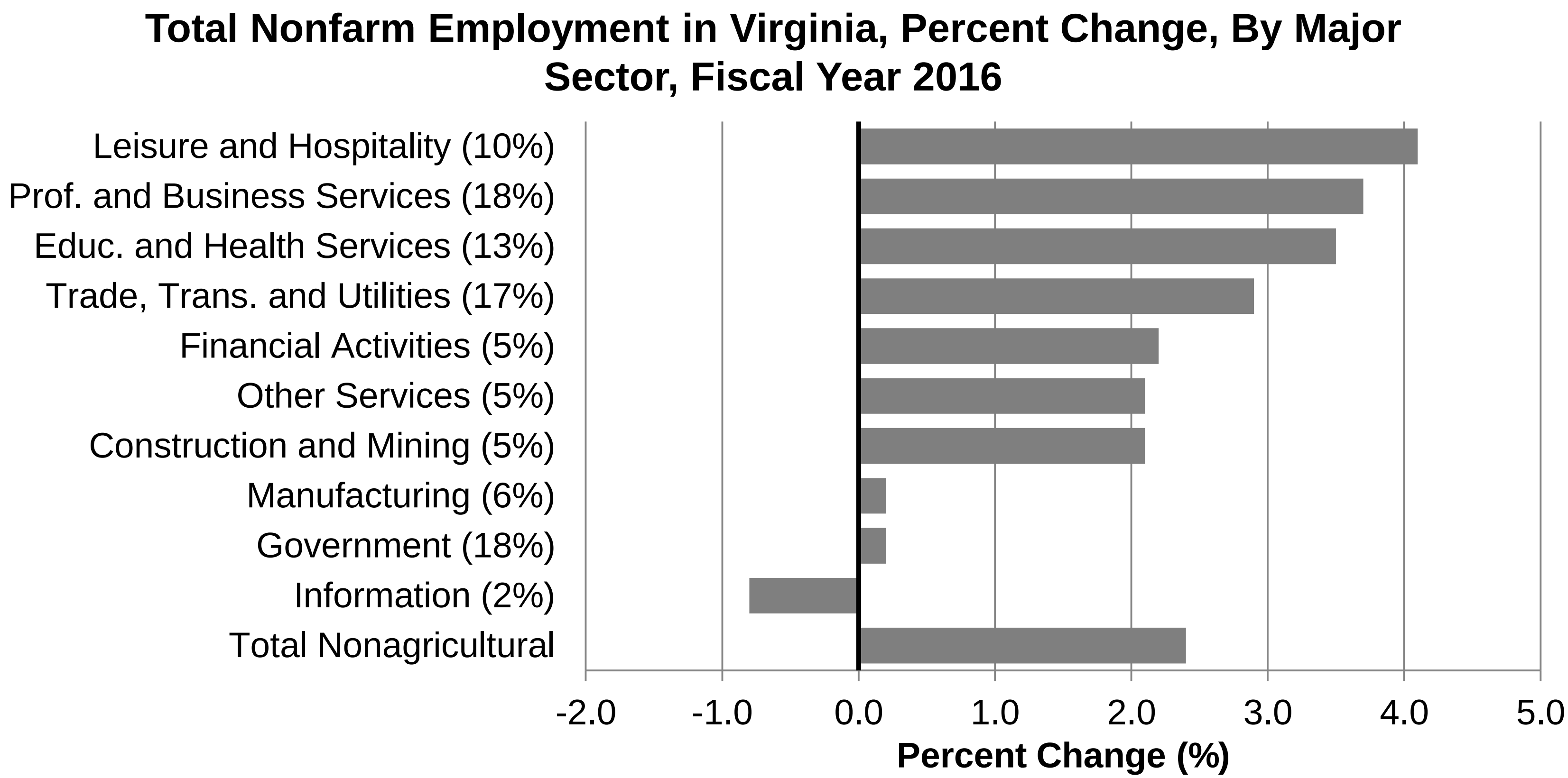
- Virginia payrolls grew 2.4 percent in FY 2016, exceeding the forecast of 1.5 percent growth. Growth was 2.1 percent in September, but gains are expected to moderate.



Source: *US. Bureau of Labor Statistics, All Employees: Total Nonfarm Payrolls [PAYEMS], and Total Nonfarm in Virginia [VANA]; retrieved from FRED, Federal Reserve Bank of St. Louis.*

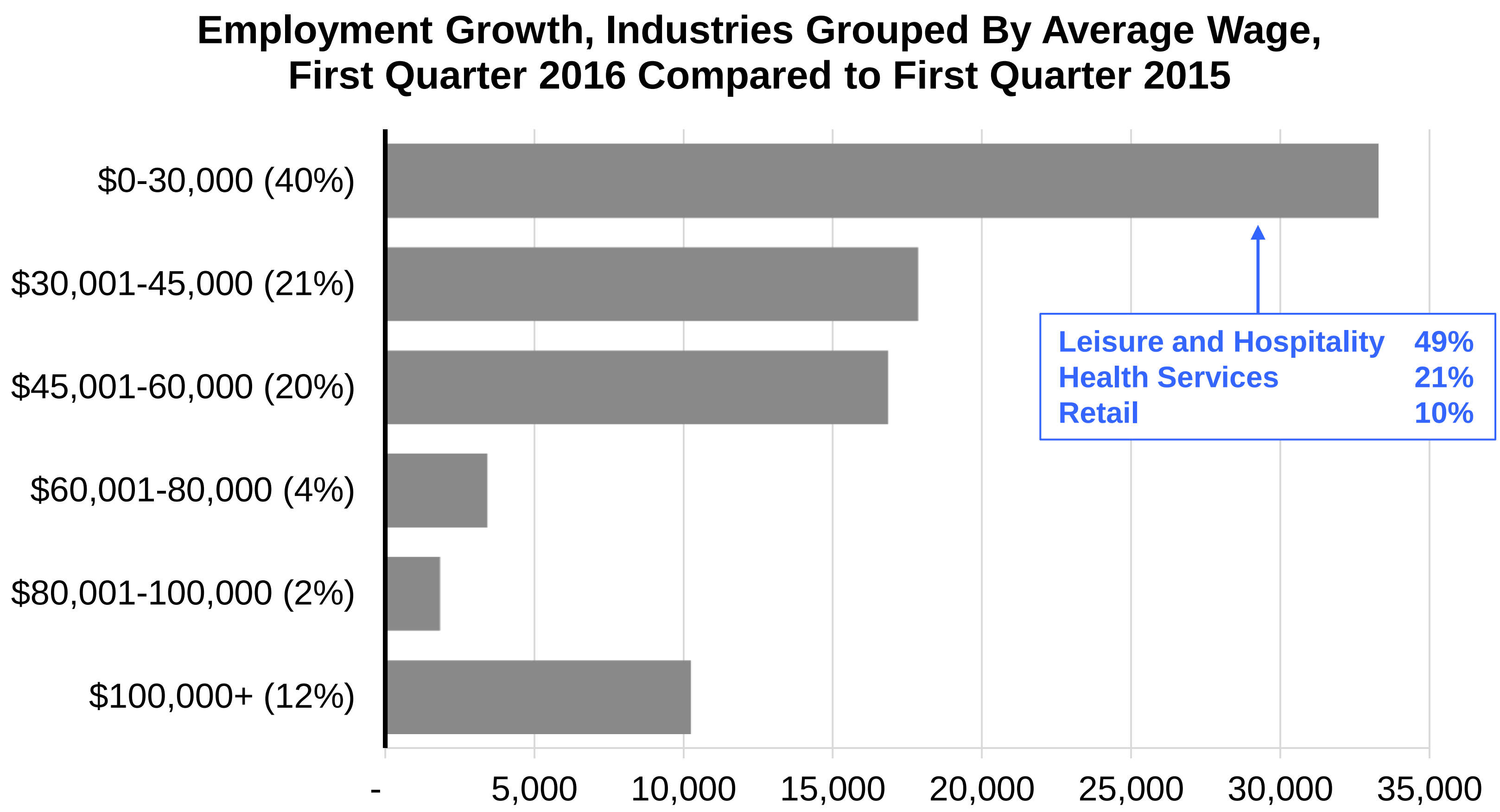
Services Are Driving Job Growth

- FY 2016 job growth was primarily in professional and business services, leisure and hospitality, and health services.



Source: *Virginia Department of Taxation, The Economic Outlook, November 9, 2016.*

FY 2016 Growth Was Mostly in Lower-Paying Jobs



Source: *Staff analysis of data from the Virginia Employment Commission, Quarterly Census of Employment and Wages for all Level 4 groups in Virginia in the first quarter of 2016 and the first quarter of 2015. Excludes totals for industries where values are suppressed to protect employer confidentiality. Totals may differ from Current Employment Statistics.*

Early Signs Point to Improved Wage Growth in FY 2017

Nationally …

- In October, average hourly earnings for all employees on private nonfarm payrolls rose by 10 cents to $25.92, following an 8-cent increase in September.
- Over the year, average hourly earnings have risen by 2.8 percent.

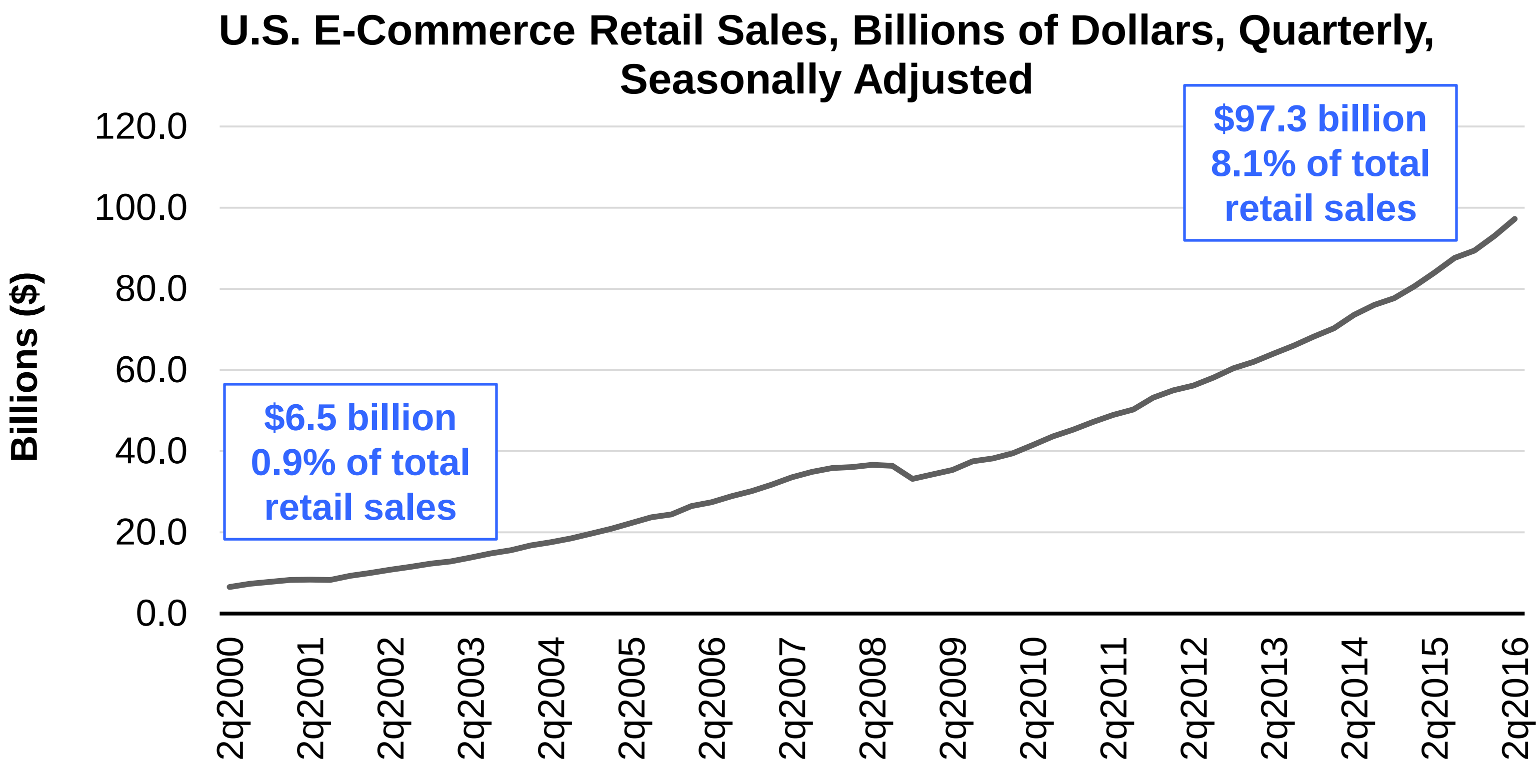
In Virginia …

- From the end of FY 2016 through September, the Commonwealth has added 33,600 jobs.
- Of those, 6,700 jobs were added in Professional, Scientific, and Technical Services, where the average annual salary is approximately $99,000.

Source: *US. Bureau of Labor Statistics, Current Employment Statistics; and, Virginia Employment Commission, Quarterly Census of Employment and Wages.*

E-Commerce Takes an Increasing Share of Retail Sales…

- Untaxed internet sales may amount to as much as $250 to $300 million in foregone state and local sales and use tax revenues in Virginia.



Source: *US. Bureau of the Census, E-Commerce Retail Sales [ECOMSA], retrieved from FRED, Federal Reserve Bank of St. Louis; and Virginia Department of Taxation.*

…But It's Not Just E-Commerce

- Spending on services and healthcare is growing faster than disposable income.
  - Pay television (cable, satellite, etc.), cell phones, internet service, and streaming services (Hulu, Netflix, Pandora, etc.).
  - Healthcare and prescription drugs.
- Car payments are also taking a bigger share of take-home pay.

Personal Consumption Expenditures, Percent Change, 2008 to 2015

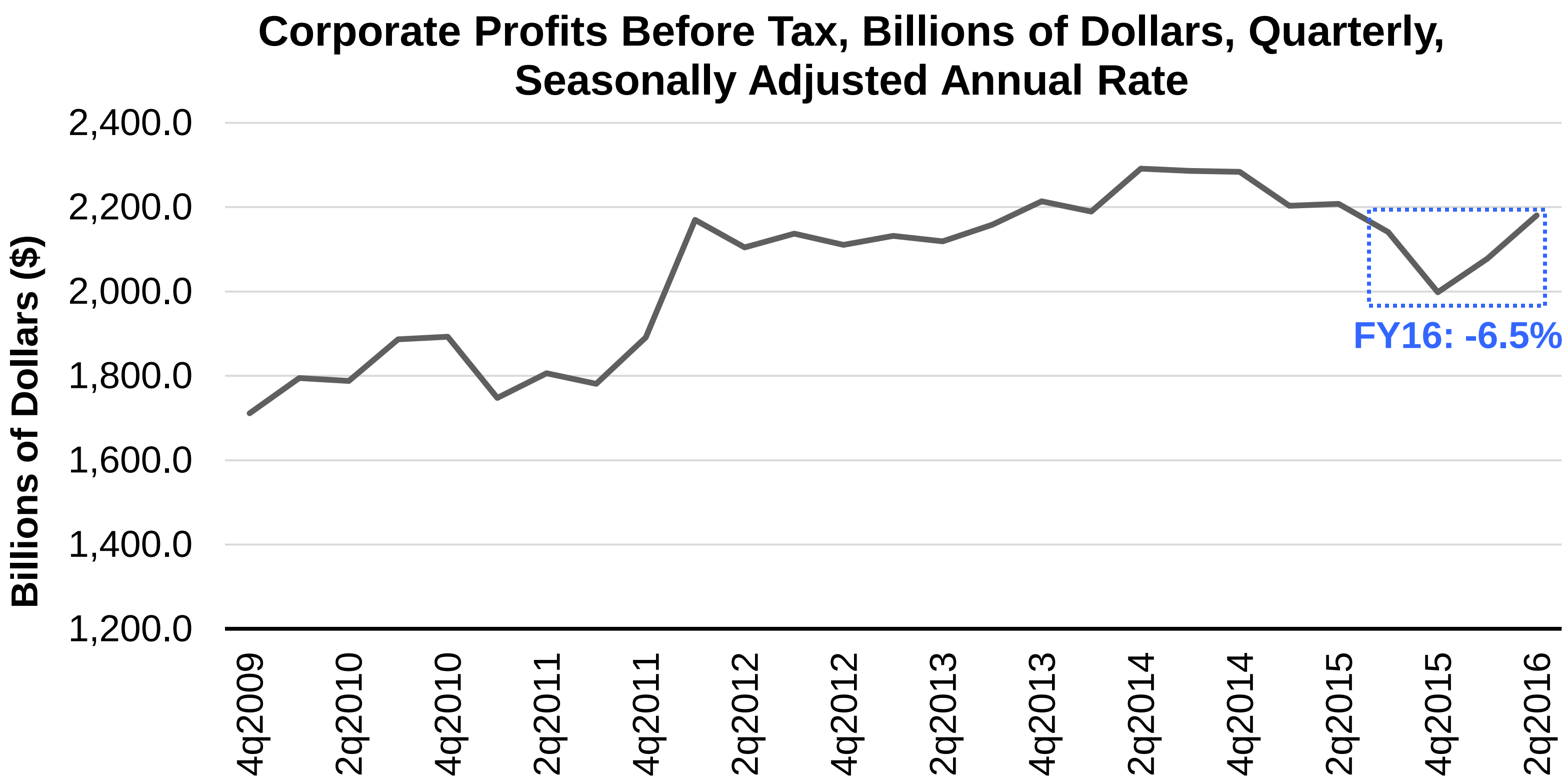
Type of Product	Change (%)
New and used vehicles	39.7%
Healthcare and pharmaceuticals	36.2
Telecom and internet	31.1
Personal disposable income	23.0

- Sales and use tax refunds are increasingly impacting revenues.
  - YTD through October refunds total $22.8 million, a $15 million increase over last year.

Source: *US. Bureau of Economic Analysis, Personal Consumption Expenditures, Personal Income and its Disposition; and, Commonwealth of Virginia Revenue Status Report (Cardinal).*

Corporate Profits Expected to Improve

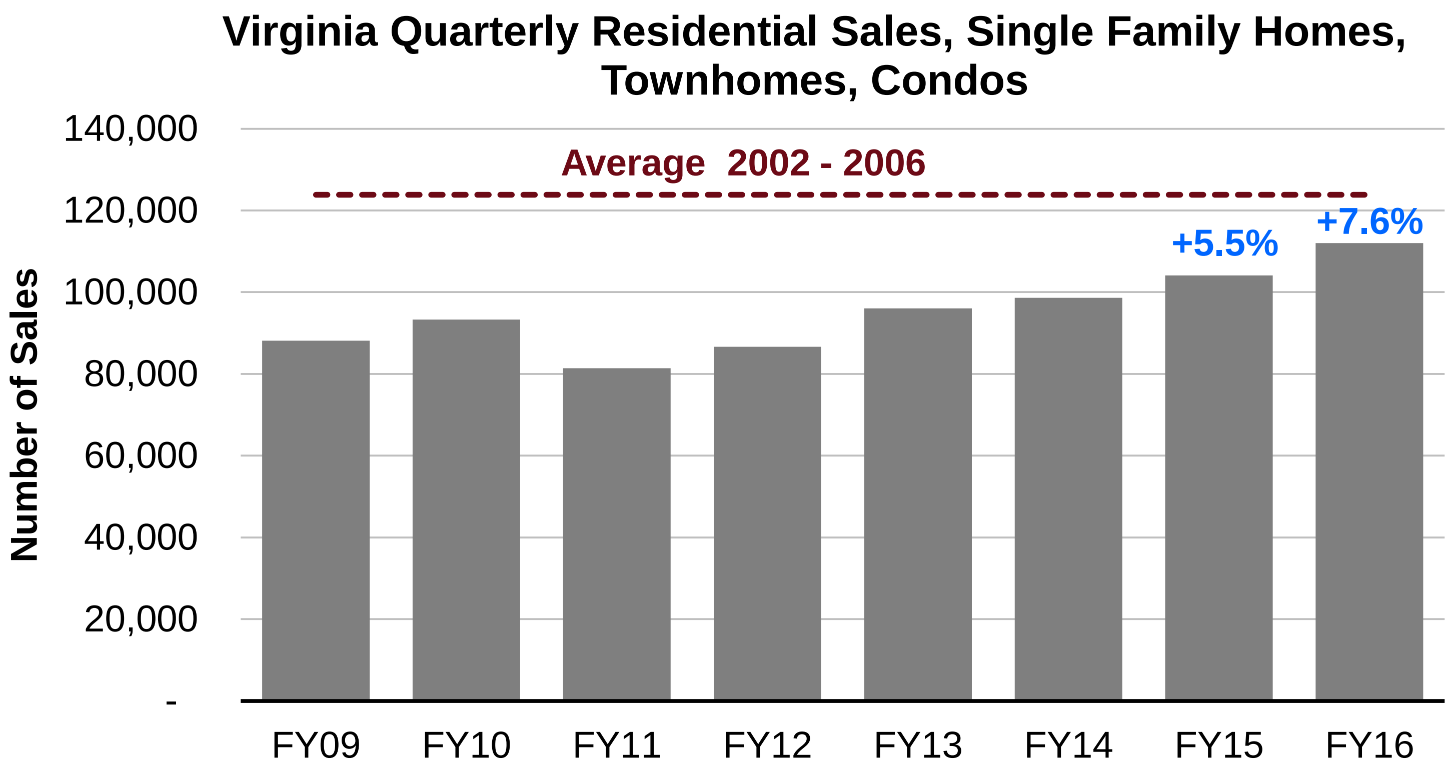
- U.S. corporate profits declined 6.5 percent in FY 2016 but year-over-year increases are expected in FY 2017 and FY 2018.



Source: *US. Bureau of Economic Analysis, National income: Corporate profits before tax (without IVA and CCAdj) [A053RC1Q027SBEA], retrieved from FRED, Federal Reserve Bank of St. Louis.*

Housing Market Continues to Show Strength

- The number of home sales in Virginia increased 7.6 percent in Fiscal Year 2016.



Source: *Virginia Association of Realtors, Virginia Home Sales Report (Second Quarter 2016). Excludes 'for sale by owner' and newly constructed homes not listed on MLS.*

FY 2016: Key Economic Variables

Fiscal Years 2016-2018 Economic Variables, Percent Change Over Prior Year, Actuals and Forecast

Percent Change (%)	FY16 Actual	FY17 Forecast	FY18 Forecast
Virginia			
Employment	2.4%	1.5%	1.0%
Average Wage	2.3	2.8	2.9
Wages & Salaries (Empl + Avg Wage)	4.7	4.4	3.9
Personal Income	4.1	3.9	4.2
Dividends, Interest and Rent	2.0	3.7	6.3
Proprietors' Income	5.7	1.3	3.9
U.S.			
Employment	1.9%	1.5%	0.9%
Corporate Profits	(6.5)	3.0	5.5
S&P 500	(0.6)	9.2	5.1

Source: *Virginia Department of Taxation, The Economic Outlook, November 9, 2016; Forecast is the IHS Markit October 2016 Standard Forecast.*

SFC Staff General Fund Revenue Forecast

- Better than expected payroll withholding in the first quarter suggests improvement; however, expectations should be tempered.
- Continued job growth is likely, but at a decelerating rate.
- Slack in labor market could dampen wage growth.
- Sales tax collections will continue to be weak due to changing spending patterns and slow growth in disposable income.
- Recordation tax collections will grow by double digits in FY 2017 as the rebound in housing continues.
- Corporate income tax collections should grow as corporate profits improve and the impact of policy actions (single-sales factor apportionment for manufacturers) lessens.
- Upside potential exists in nonwithholding, depends on final payments which are largely linked to market performance.

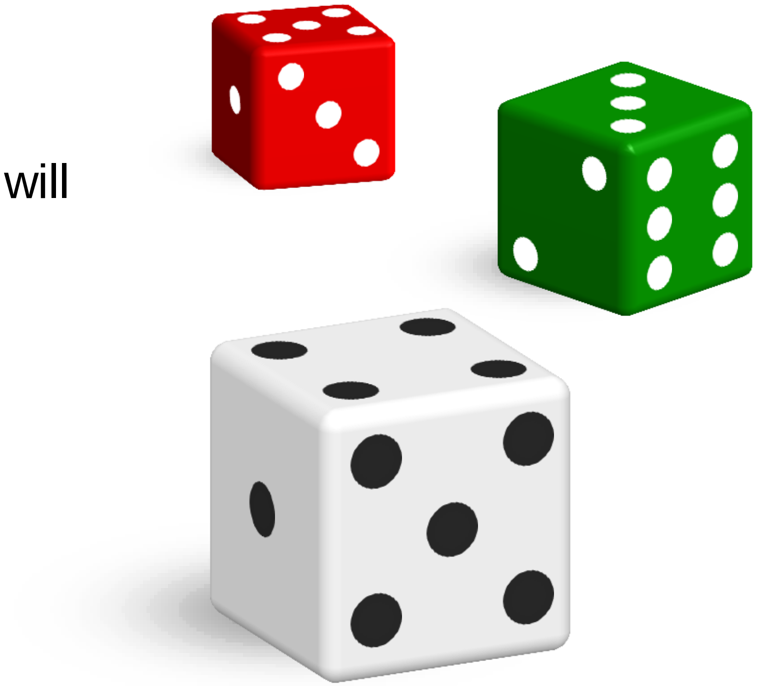
SFC Staff General Fund Revenue Forecast

Senate Finance Committee Staff GF Estimates

($ in millions)	FY 2017	FY 2018
SFC GF Revenue Forecast	**$18,562.4**	**$19,014.6**
Growth by Revenue Source		
Withholding	3.3%	3.2%
Nonwithholding	3.5	0.6
Refunds	3.1	3.3
Sales	1.2	1.9
Corporate	3.1	1.3
Recordation	12.0	5.6
Insurance	2.2	4.5
All Other	(2.7)	0.7
Total GF Revenue Growth	**2.9%**	**2.4%**
SFC Transfer Estimate	$554.9	$566.2
Total GF Resources	**$19,117.4**	**$19,580.8**
GF Resources Above Interim Forecast	**$219.4**	**$5.2**

Risk of Recession?

- Recession not imminent, but risk is increasing.
- The October Wall Street Journal survey puts the probability of a U.S. recession in the next 12 months at 20 percent, more than double the chance predicted in summer 2015. Some economists put the chance of recession as high as 50 percent or more.
- 63 percent of National Association for Business Economics (NABE) survey respondents expect the business cycle will peak in 2018 or 2019.



Source: *Wall Street Journal Economic Forecasting Survey, October 2016; and NABE Outlook, September 2016.*

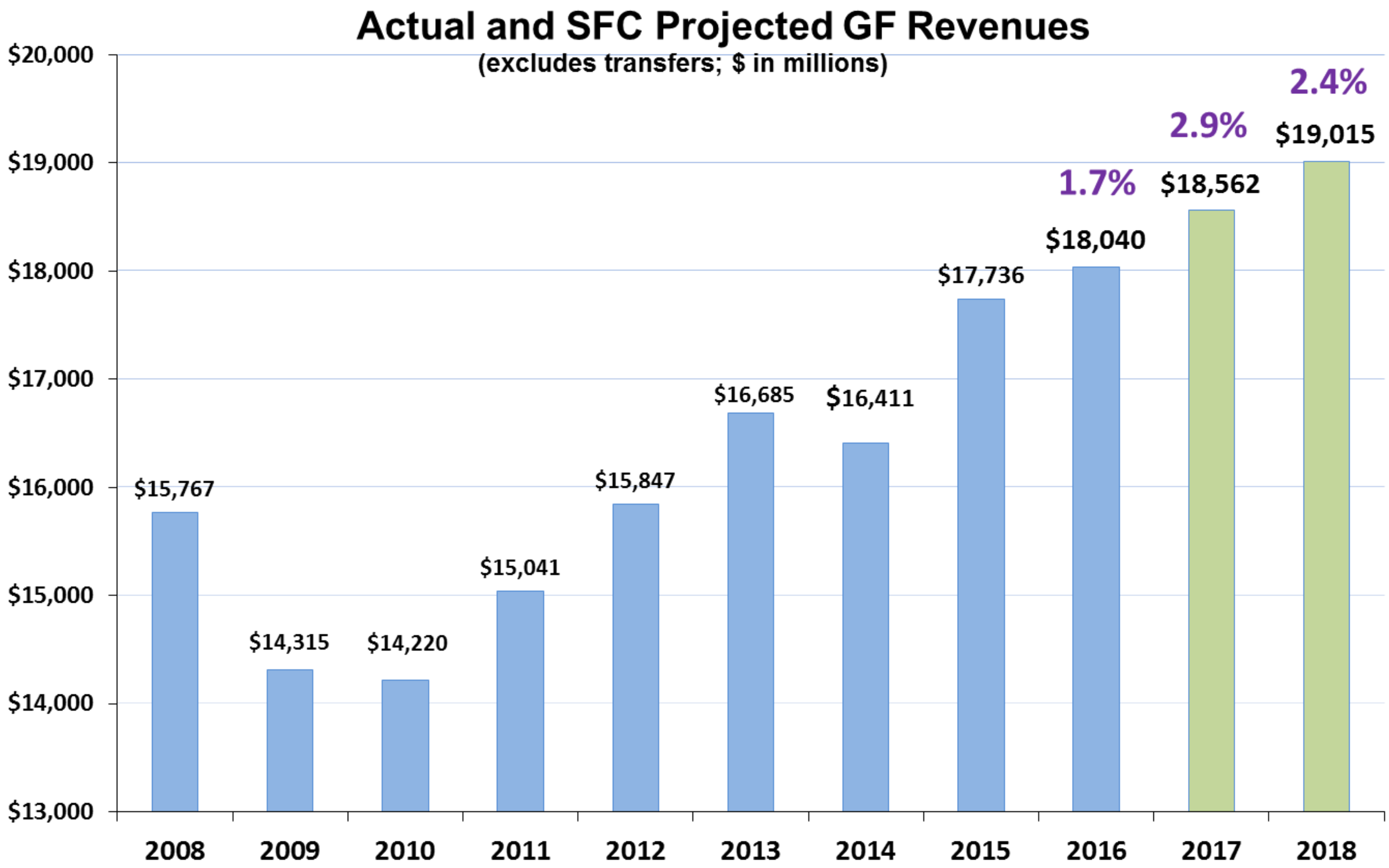
Next Steps:
Consensus Revenue Forecasting Process

- **Joint Advisory Board of Economists (JABE) -- met in early November.**
  - Economists from private sector and academia; input from Global Insights and Moody's Analytics.
  - Dept. of Taxation and Secretary of Finance develop forecast based on input.

- **Governor's Advisory Committee on Revenue Estimates (GACRE) -- meets November 28th.**
  - Cross-section of leaders from Virginia business and industry, General Assembly leadership.
  - Members review forecast developed by Governor's staff.

- **Official forecast proposed in Governor's budget as introduced.**
  - Modified by tax policy changes adopted through legislation.
  - Changes in assumptions adopted by money committees in the budget.

Slow, but Steady, Revenue Growth Projected



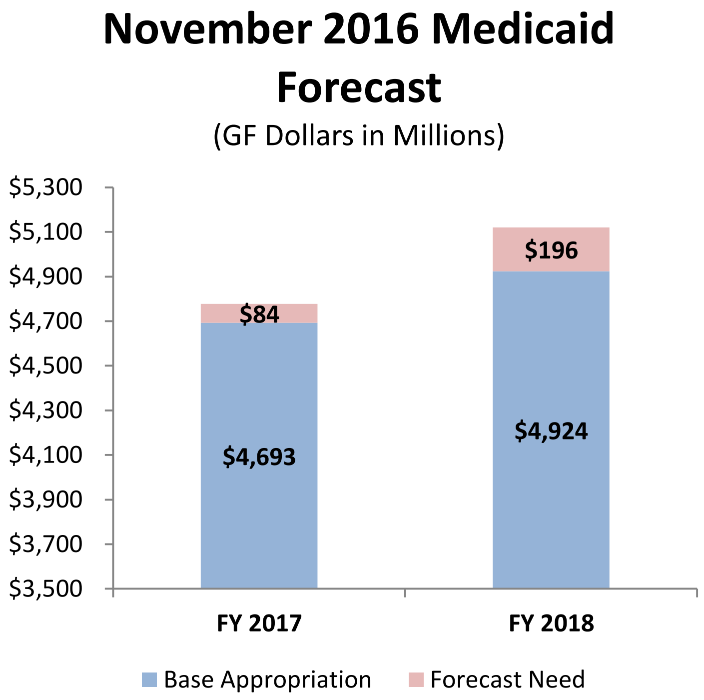
Additional Budget Pressures

- Medicaid, CSA, and medical costs in correctional facilities dominate required new spending.

(GF $ in millions)	FY 2017	FY 2018	2016-18
Medicaid Utilization & Inflation	$84.3	$196.3	**$280.6**
Children's Services Act (CSA)	23.8	34.9	**58.7**
DOC Inmate Medical Costs	15.7	14.2	**29.9**
Employee Health Insurance	0	9.9	**9.9**
Unbudgeted IT Costs	3.0	0	**3.0**
Total	**$126.8**	**$255.3**	**$382.1**

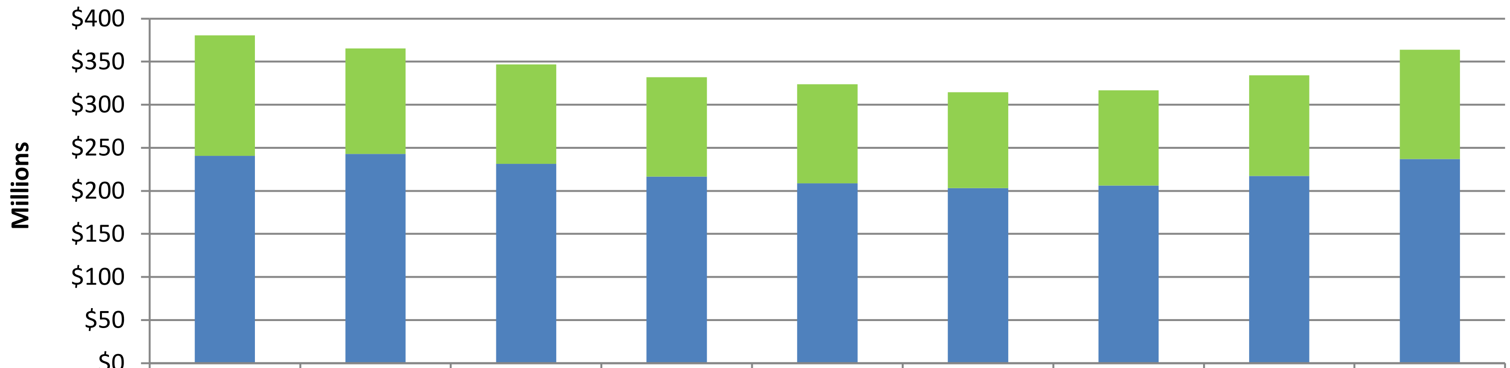
Medicaid Forecast

- Additional funding of **$281 million GF** for fiscal years 2017 and 2018 is required to address caseload and cost growth. Spending is projected to increase by 7.4% in FY 2017 and 4.3% in FY 2018. Last year's forecast projected growth of 3.8% and 2.9%, respectively.
  - Federal increases in Medicare Premiums account for $89 million GF of the growth.
  - Increasing utilization of community behavioral health services accounts for $86 million GF.
  - In FY 2016, enrollment growth was 2.6%. Year-to-date enrollment growth is up 1.6%. (Full benefit Medicaid enrollees).
  - Fee-for-service acute care and early intervention services reflect higher utilization.
  - Non-waiver long-term care and pharmacy rebates provide offsetting savings.



Children's Services Act

- After a few years of declining spending, growth returned in FY 2014.
- FY 2015 growth was over 5% and in FY 2016 over 9%.
- The majority of this growth is due to **private day placements** through special education in public schools.
- Projected GF need in FY 2017 is **$23.8 million** and in FY 2018 is **$34.9 million**.



	FY08	FY09	FY10	FY11	FY12	FY13	FY14	FY15	FY16
Local Match	$140	$122	$116	$116	$115	$111	$111	$117	$127
State Match	$241	$243	$231	$217	$209	$203	$206	$217	$237

2017 Session Budget Outlook

- With SFC staff revenue adjustment, combined with budget pressures, a budget problem of about **$800 million** remains to be addressed.

2016-18 Amended Budget
(GF $ in millions)

	FY 2017	FY 2018	2016-18
Ch. 780 Official	$19,480.1	$20,229.9	$39,710.0
Aug Revenue Adjustment	(582.1)	(654.3)	(1,236.4)
Interim Forecast	$18,898.0	$19,575.6	$38,473.6
Plus FY 16 Shortfall	(279.3)	0.0	(279.3)
Governor's Strategies	875.1	0.0	875.1
Balance to Address	$13.7	($654.3)	($640.6)
SFC Revenue Outlook	$19,117.4	$19,580.8	$38,698.2
$ Above Interim	219.4	5.2	$224.6
Add: Budget Pressures	(127.0)	(255.0)	(382.0)
Balance/(Shortfall)	**$106.1**	**($904.1)**	**($798.0)**

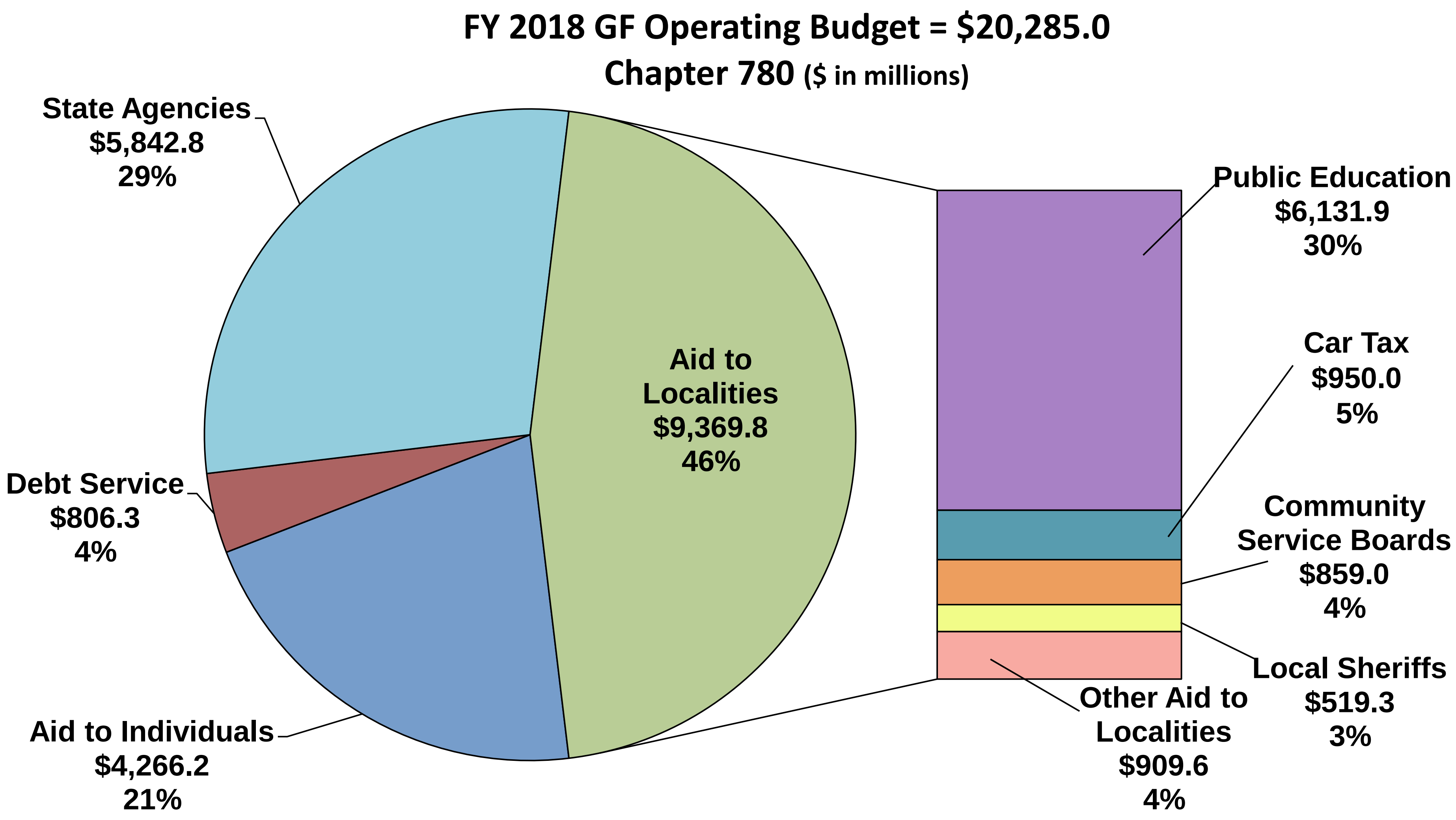
Strategies to Close the Gap in FY 2018

- Withdrawal of an additional $225 million from the Rainy Day Fund will be available.
- Second year of strategies used in 2017, such as reverting the planned salary increase, or deferring adjustment to AST.
- Most low hanging fruit – already plucked.
- Avoid using “budget gimmicks” that will have to be back-filled this time next year when the biennial budget is developed.
  - Keep resources and expenditures in balance.
  - Big ticket savings items, such as deferring VRS (as in 2010), have become the “third rail”.
- User fees, other revenue increases may be an option.
- Spending cuts -- a combination of across-the-board and targeted -- will be required to close any remaining shortfall.

Strategies to Close the Gap in FY 2018

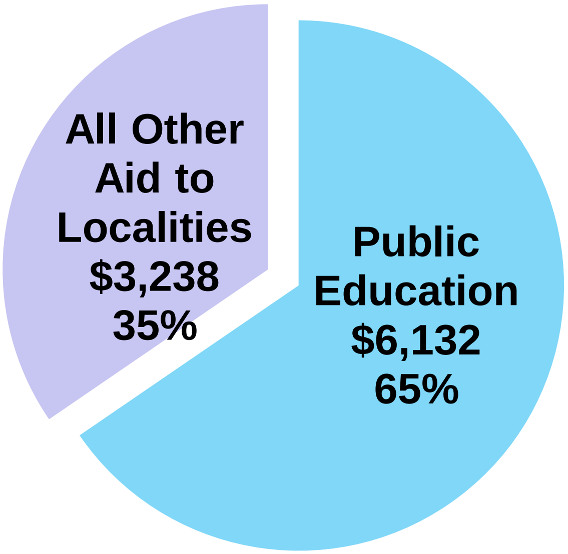
Strategy	GF $ in millions
Withdrawal from Revenue Stabilization Fund	**$225.0**
Remove Year 2 of Scheduled Pay Increase	221.0
Higher Education 7.5% Reduction	114.1
Other State Agency 7.5% Reductions	79.3
Recover HE NGF Share of VRS Savings	41.3
Adjust Accelerated Sales Tax (AST)	27.0
Additional Targeted Reductions/Miscellaneous	*90.3*
TOTAL	**$798.0**

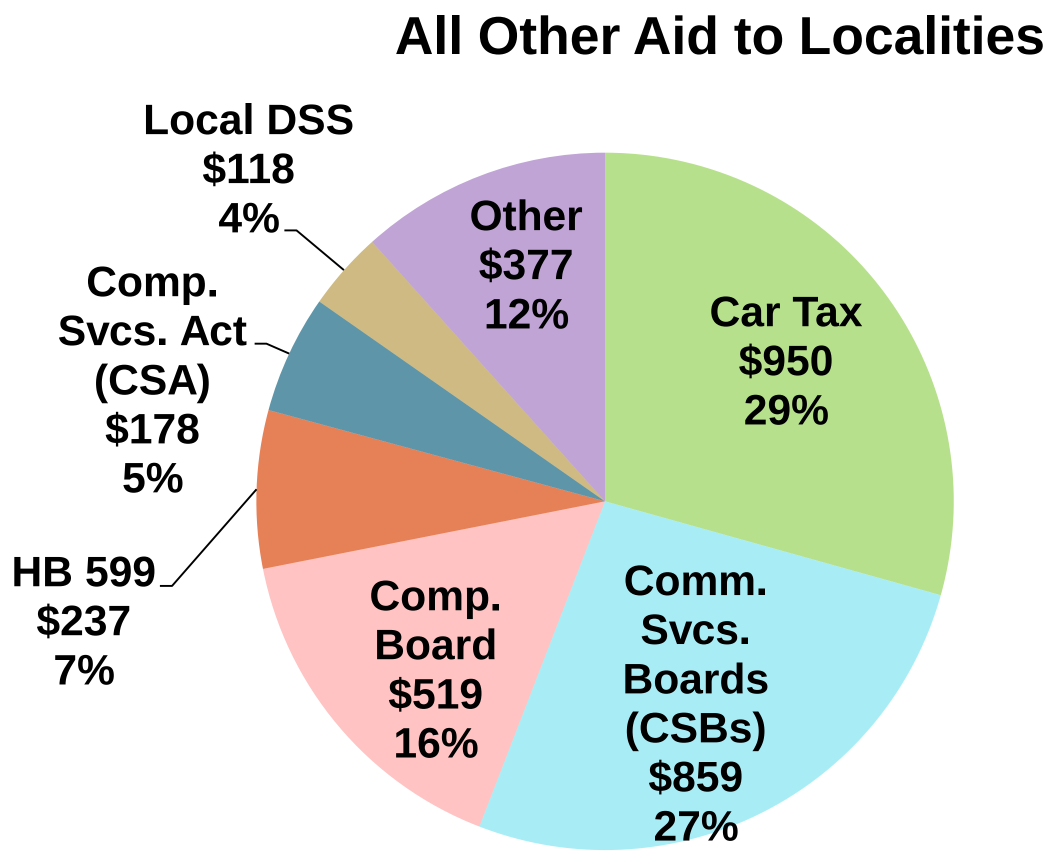
General Fund Budget Drivers



Aid to Localities
FY 2018 = $9.4 billion

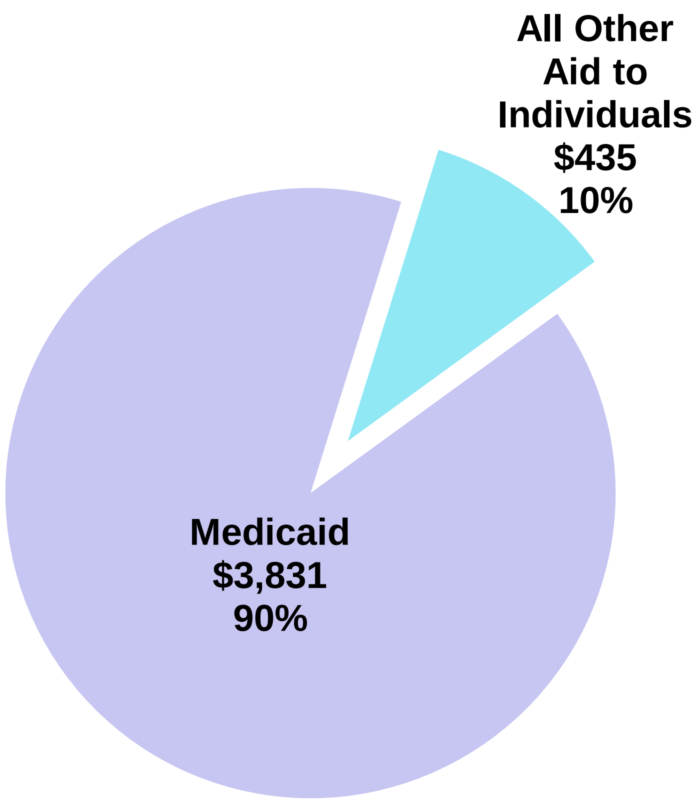
Ch. 780, GF $ in millions

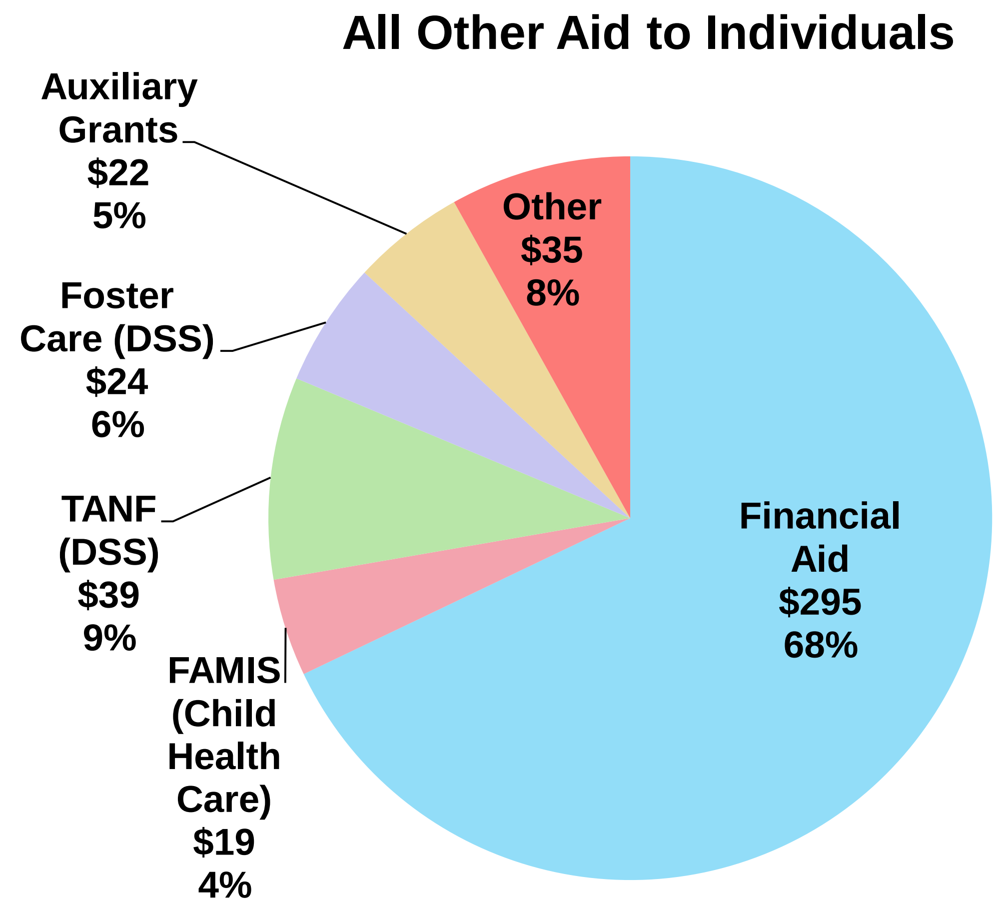




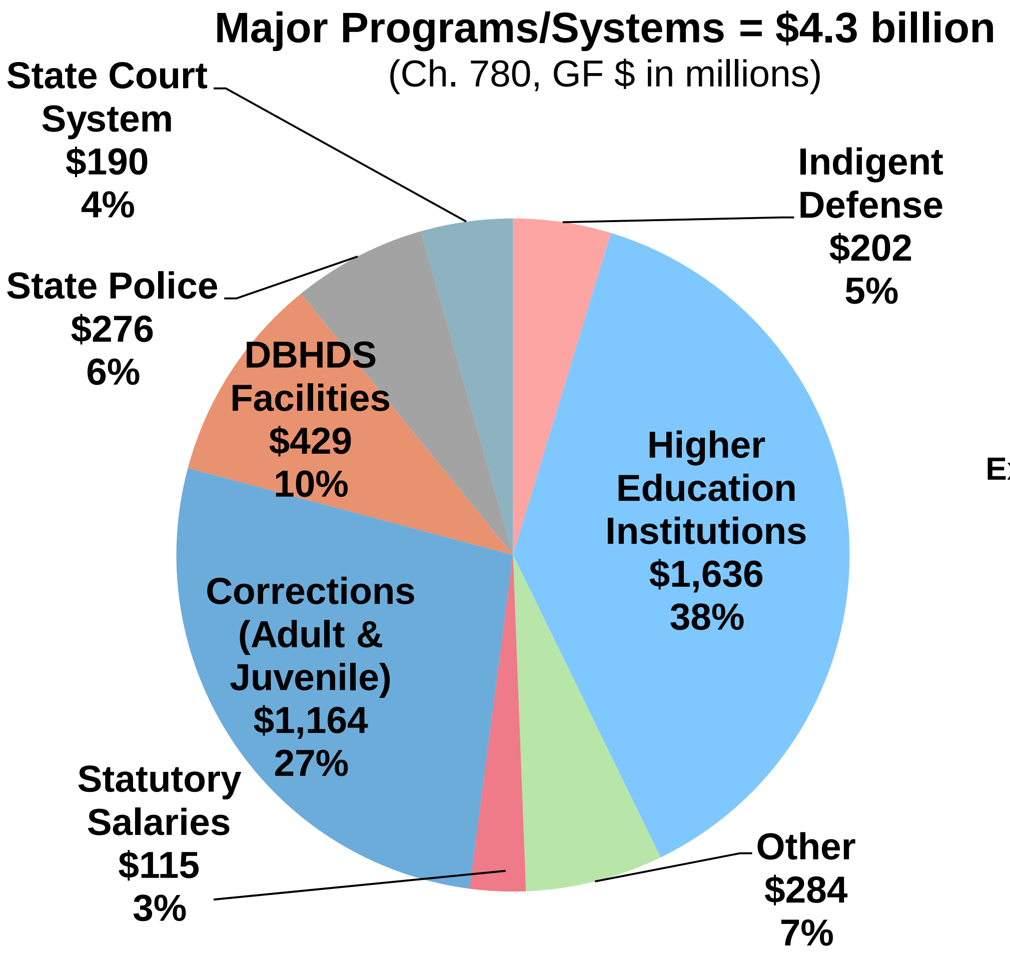
Aid to Individuals
FY 2018 = $4.3 billion

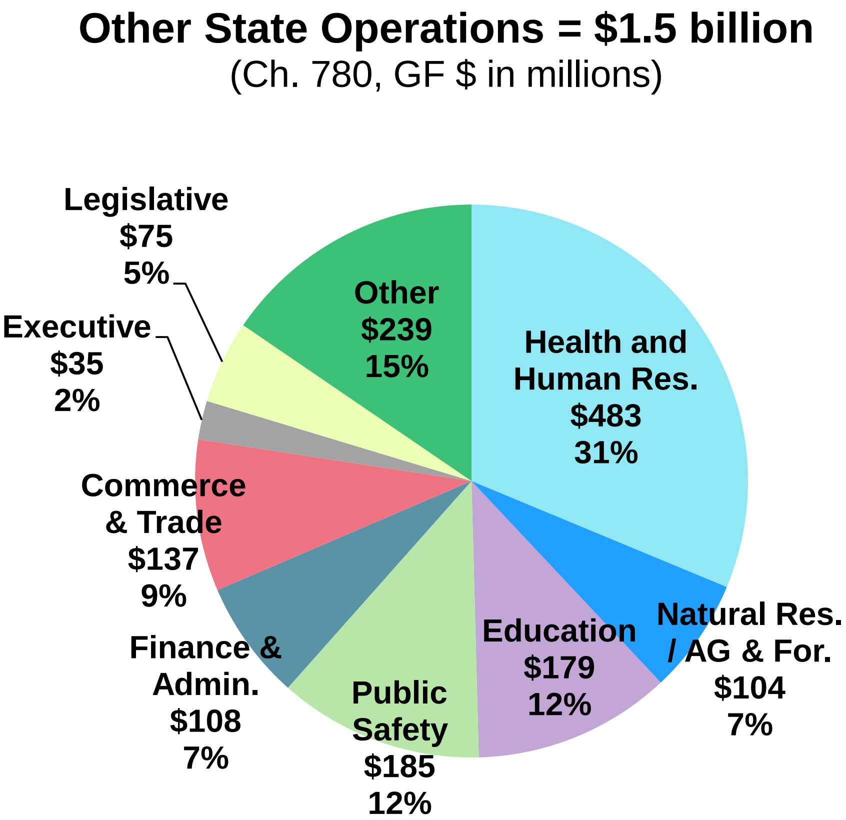
Ch. 780, GF $ in millions





Major Systems & Other State Programs
FY 2018 = $5.8 billion





Challenges of the 2017 Session

- Virginia's economy continues to slow its pace, with modest revenue growth.
  - August interim forecast appears reasonable, with some tweaks to withholding, and modest revenue adjustments in both years.
  - Additional revenue will not cover the additional costs of Medicaid and other high priority funding items.
- Budget shortfall of about **$800 million** remains, assuming proposed FY 2017 actions adopted.
  - Rainy Day Fund can be used to address about $225 million of shortfall.
  - General fund budget reductions will be required.
  - Challenge to avoid cutting new investment, and restore pay raises.
- Objective: Keep budget structurally balanced and maintain flexibility.